

WORKING WITH INTERNATIONAL VENTURE CAPITAL FUNDS PERSONAL OBSERVATIONS

2019

Following is a Good Start

- Make cold calls
 - ... this is the hottest thing on earth!
- Don't prepare anything
 - ... nobody is cooler out there
- Always insist on NDAs
 - ... all top secret, man!
- Valuation is value
 - ... \$\$\$ is all what counts
- Term sheet? What term sheet?
 - ... this is just dry lawyers' stuff
- Here are my terms
 - ... you want me to negotiate?
- Reject a rejection
 - ... and ideally shout at them!



Why Start-Ups Fail



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What Makes Your Proposition a „Hot One“ ...

- Proven team with a great **track record**
- Outstanding **metrics**
- **Unique** technology or distribution advantage
- **Other VC** firms are ready to invest
- A warm **intro**
- You are in a **VC-hyped category**
- Your company **fits** the VC's investment thesis perfectly

Before Working with VCs

- The mechanics of the VC model
 - Most VCs are **intermediaries**
 - Some platforms invest their own money
- The most relevant **values** to expect from VCs
 - Money
 - Expertise / knowledge
 - Network / mentorship
 - Operational support
 - Branding

Is the VC model aligned with your aspirations as an entrepreneur, or rather not?

Preparing for Fundraising

- **Shortlist** of relevant VCs
 - Investment stage
 - Seed, series A, B, C...
 - Investment scope
 - Investment thesis
 - Blogs, latest deals
 - “Value added” / operational support

 - Expertise in your area?
 - Any successes?
 - Fund size?
 - Stage in their life cycle?
- First “light” **reference** checks
 - Other founders
 - Business angels
 - Incubators and accelerators
- Create fundraising **material**
- Contact

The Relationship with a VC

- Your company is the product ...
- ... and you're **selling an equity ownership** in your company ...
- ... **but** actually you are selling trust & confidence that you are going to **build something enormously valuable** ...
- ... and that you're going to be enjoyable to work **hand-in-hand** with **over the coming decade** of each other's lives

This actually sounds more scary than entering a marriage ...

The VC Machine

- Partnership
 - **Number** of partners
 - Active and less **active** partners
 - Who has “**pull**” to get deals done
 - Which partners work well with which other partners
 - Who are the more **optimistic** partners ...
 - ... and who are the most generally skeptical ones
 - How does the partnership typically make its final **investment decisions**
- Non-Partner Investment Staff
 - Sourcing deals for partners
 - Initial deal screening with a partner
 - Assisting with due diligence
 - Building models to evaluate the deal
 - Completing due diligence post partner meeting for questions raised there

The Pitch

- Know your **audience**
 - Who are you meeting with?
- Briefly warm up, then straight to the point ...
 - The succinct tagline
- The **numbers**
 - If you have strong metrics, then bring this up early and be specific
 - If your metrics are weak, focus on how massive the problem is...
- The story of the **growth** potential
 - ... supported by market metrics
- The product **story**
- The product **value**
 - Its benefits and features
- **How** do you intend **to make money**
 - What makes you better than your competition
 - How are you monetizing
 - Are you already profitable
- Your **team**
 - ... in times of trouble ...

The Pitch Book

- From a long-form to the elevator pitch ...
- Of Power Point presentations which are too long ...
- Excellent Executive Summary
 - The **problem** the startup will be **solving**
 - The **size of the market** the startup will be addressing
 - The sustainable **competitive advantage**
 - The expected **revenues and costs** of the startup
 - ... supported by realistic and detailed assumptions and projections
 - Description of the startup's management **team**
 - **Exit** for the investors



How VCs Assess Opportunities

- An analyst / associate / principal check whether proposal in line with VC's **investment scope & thesis**
- If promising
 - **Internal discussion**
 - Partners
 - Investors
 - Experts
 - ...
 - Deal Memo
- **Iterative, ongoing decision making**
 - Unanimity from all the partners
 - Certain percentage
 - “Super user” partner / veto
 - Sponsoring partner ownership
 - ...
- Observations
 - VCs are **conviction** driven
 - Almost certainly no deal, if even one partner has deep conviction “against” a decision
 - Frequently, partner have **equal say**
 - Input from board partners and non-partner investment staff
 - Policy of “**no retribution**” and “**no reciprocity**”
 - Decision making can be draining

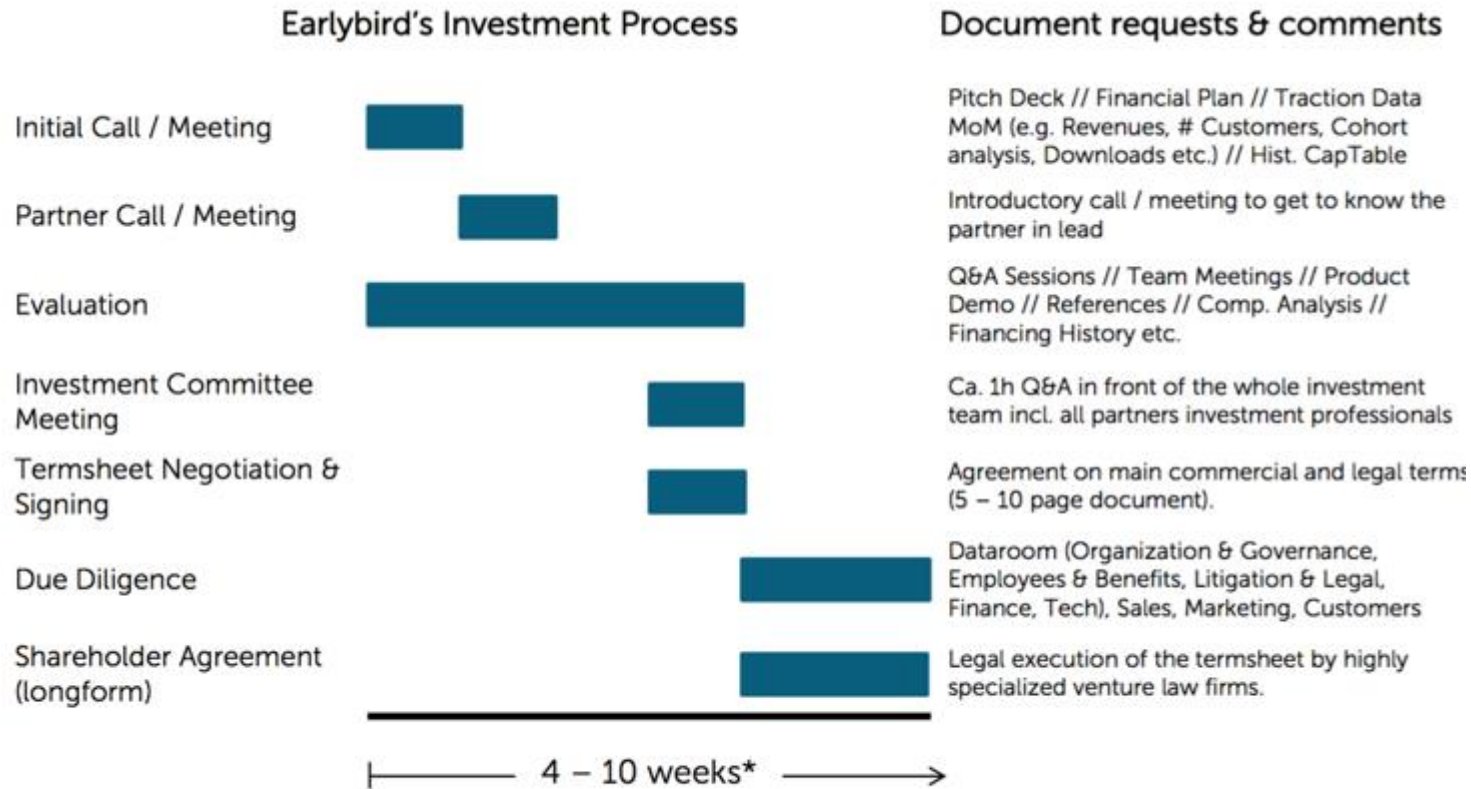
Feedback Alternatives

- **No**, not interested ...
 - Should I be mad?
 - Should I ask why?
 - I really want this investor with me: Should I insist?



- We're **looking** at you / **into it** ...
 - If your company is “hot”, you'll probably meet a Partner quickly
 - If not, you'll probably interact multiple times with associates or principals first
 - If the investors need to build conviction, they'll ask you for more material
- You **don't receive** any **answer**
 - Not convinced enough to explore the opportunity in more depth
 - Currently under water and having other priorities
 - Forgot about you
 - It's a bad VC ...

Indicative Timetable



* Note: The timeline is only an approximation to give you a high level overview of our processes.

The Term Sheet

- **Non-binding** document ...
- ... meant to record two or more parties' **intentions** ...
- ... to enter into a **future** agreement ...
- ... based on specified - but **incomplete** or preliminary - terms

Thoughts on Term Sheet Negotiation

- **Listen!**
- VC attention and support are **limited** resources
- Entrepreneurial overconfidence
- Your **leverage** is not only a function of your alternatives
- **Transparency** is often less costly than one may fear
- Building **trust** is most easily when the other party is vulnerable
- The allure of valuation
- The wise power of **bargaining**
- The **terms the VC accentuates**

Due Diligence is a Two-Way Street

- Ask on certain VC **aspects** which are important for you
 - Concrete **examples**
- Cross-reference checks with **founders of their portfolio**
 - Ask for introductions to the ones you want to talk to
- Ask yourself whether you **trust** the individuals you've been interacting with during the overall process
- Ask the VCs **what** they do **when a portfolio company doesn't do well**

Thoughts on Valuation



Valuation Aspects

- **Experience** and past success of the founders
 - “Serial” entrepreneurs present less risk, often command higher valuations
- The size of the market **opportunity**
- **Proprietary** technology already developed
- Any **initial traction**
 - Revenue, partnerships, satisfied customers, favorable publicity, etc.
- Progress towards a minimally **viable product**
- **Recurring revenue** opportunity
- **Capital efficiency** of the business model
 - Will the company need to burn through significant capital before reaching profitability?
- Valuations of **comparable** companies
- Whether the company is “hot”
 - ... and **pursued by other investors**
- The current **economic climate**
 - Valuations generally climb when the overall economy is strong

Post-Investment

- **Interaction** with investors
 - Recurring: **Board Meetings**
 - Keep the board members informed of the company's progress
 - Discuss short and long term plans
 - Take decisions that require the approval of the board members
 - Recurring: **Check-ins**
 - One-time interactions
 - Feedback sessions
 - Recruiting
 - Raising your next round
 - Portfolio events
 - Portfolio platform / online groups
- **Optimize investor relationship**
 - Set **expectations**
 - “Hands-on” type or very light?
 - Founding team “weaknesses” that could be filled by investors knowledge (education) or network (hiring)?
 - Demand for industry specific knowledge or specific value add that investors offer
 - Understand investor's profile / **strengths**
 - **Pro-active & structured approach**
 - Provide all required information upfront
 - Clear call to action
 - Not at the last second and share a deadline

When Things Go Wrong

- **Good VCs will help** you, if your company is not doing well ...
- ... while **bad VCs will screw you up**

In Conclusion

- Act greedily
- Be close-minded
- Ask for too little
- Cover your passion
- Don't have a solid plan

Selected Term Sheet Aspects

Selected Term Sheet Aspects

- **Form of the Venture Capital Investment**
 - Convertible promissory note
 - Convertible into company stock in its next round of financing at a discount (eg 20%)
 - Maturity date (often 12 months from issuance) and will bear interest (4% to 8% is common)
 - No valuation is set for the company at this time.
 - Sometimes with “cap” on the valuation for purposes of the conversion rate
 - Quick and easy to document
 - Convertible preferred stock
 - Rights, preferences and privileges set forth in the company’s certificate of incorporation
 - Preference over common shareholders on a sale of the company
 - Upside potential of being able to convert to common stock of the company
 - Most Series A financing rounds are done as convertible preferred stock
- **Vesting of Founder Stock**
 - Vesting credit for time already served with the company?
 - Vesting schedule of less than (usual) 48 months? No schedule?
 - Accelerated vesting accelerate, (employment termination; sale of the company)?

Selected Term Sheet Aspects (cont´d)

- **Composition of the Board of Directors**
 - Allocation usually follows share ownership
 - Illustrative scenarios
 - 3-person Board, with two chosen by the founders, and one chosen by the investors
 - 3-member Board, one chosen by the founders, one chosen by the investors, and one independent director mutually agreed upon
 - 5-member Board, two chosen by the founders, two chosen by the investors, and one independent director mutually agreed upon
- **Liquation Preference of the Preferred Stock**
- **Participating vs. Non-Participating Preferred**

Selected Term Sheet Aspects (cont'd)

Participating liquidation preference

- Investor invested \$1M in a \$6M pre-money valuation (\$7M post) with a 2x participating liquidation preference
 - Investor owns 14.4% ($\$1M/\$7M$) of the company and would get upside on any change of control
- If the company sold for \$15M the investor would get back 2x of their investment first for \$2M ($2 \times \$1M$) and ...
- ... the rest of the remaining \$13M ($\$15M - \$2M$) would be distributed among all shareholders
- Investor hence receives an additional \$1.9M ($14.4\% \times \$13M$), a total of \$3.9M ($\$2M + \$1.9M$)

Non-Participating liquidation preference

- Investor has a 2x non-participating liquidation preference and a 14.4% ownership of a \$7M post-money valuation
- If the company is sold for \$15M, the investor would have a choice of **either** receiving \$2M ($2 \times \$1M$) for their liquidation preference ...
- ... or \$2.2M ($14.4\% \times \$15M$) for its participation, therefore \$2.2M

Selected Term Sheet Aspects (cont'd)

- **Protective Provisions / Veto Rights of the Investors**
 - Amendment of the company's charter or bylaws to change the rights of the preferred
 - Creation of any new series or class of shares senior to, or on parity with, the preferred
 - The sale or liquidation of the company
 - Payment of dividends
- **Anti-Dilution Protection**
- **Right to Participate in Future Financings**
- **Stock Option Issues**
 - Venture investors will want to ensure that the company has a stock option pool for future equity grants, typically 10% to 20% of the company's capitalization, with later-stage companies having smaller pools

Selected Term Sheet Aspects (cont´d)

- **Redemption Rights**
 - Investors may, by majority vote at any time starting five years after their investment, elect to be redeemed (repurchased at their original purchase price), with payments made over a three-year period in equal installments
- **Information Rights**
- **Insurance Obligations**
- **Rights of First Refusal/Co-Sale Rights**
- **Drag-Along Rights**
- **Registration Rights**
- **Exclusivity/No Shop**
- **Confidentiality**
- **Dispute Resolution**
- **Due Diligence by VC Investors**

Selected Legal Documents


 Voting Agreement

 Term Sheet

 Stock Purchase Agreement

 Right of First Refusal and Co-Sale Agreement

 Model Legal Opinion

 Management Rights Letter

 Investor Rights Agreement

 Indemnification Agreement

 Certificate Of Incorporation

Excursion – Valuation of Startups

Standard Forecast

Year		0	1	2	3	4	Residual
Cash Flow Forecast		-5,00	-7,00	-2,00	0,00	5,00	10,00
Unadjusted Cash Flows							
Discount Factor	30,0%	1,00	0,77	0,59	0,46	0,35	Sum
Discounted Cash Flows		-5,00	-5,38	-1,18	0,00	1,75	-9,82
Terminal Value							
Growth	2,0%	35,71					
Discounted TV		12,50					
Enterprise Value		2,69					

Forecast with Survival Probability

Year		0	1	2	3	4	Residual
Cash Flow Forecast		-5,00	-7,00	-2,00	0,00	5,00	10,00
Probability of Success of Previous Stage			40,0%	60,0%	80,0%	90,0%	95,0%
Cumulative Probability of Survival		100,0%	40,0%	24,0%	19,2%	17,3%	16,46%
Probability-adjusted CF Forecast		-5,00	-2,80	-0,48	0,00	0,86	1,65
Adjusted Cash Flows							
Discount Factor	12,0%	1,00	0,89	0,80	0,71	0,64	Sum
Discounted Cash Flows		-5,00	-2,50	-0,38	0,00	0,55	-7,33
Terminal Value							
Growth	2,0%	16,46					
Discounted TV		10,46					
Enterprise Value		3,13					

Valuation Approach – Year 0

Year	0	1	2	3	4	Residual
Cash Flow Forecast	-5,00	-7,00	-2,00	0,00	5,00	10,00
Unadjusted Cash Flows						
Discount Factor	30,0%	1,00	0,77	0,59	0,46	0,35
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Discounted Cash Flows	-5,00	-2,50	-0,38	0,00	0,55	-7,33
Terminal Value						
Growth	2,0%	16,46				
Dicounted TV		10,46				
Enterprise Value		3,13				

Valuation Approach – Year 1

Year		0	1	2	3	4	Residual
Cash Flow Forecast			-7,00	-2,00	0,00	5,00	10,00
Unadjusted Cash Flows							
Discount Factor	30,0%		1,00	0,77	0,59	0,46	Sum
Discounted Cash Flows			0,00	-5,38	-1,18	0,00	-6,57
Terminal Value							
Growth	2,0%	35,71					
Dicounted TV		16,26					
Enterprise Value		9,69					
Year		0	1	2	3	4	Residual
Cash Flow Forecast			-7,00	-2,00	0,00	5,00	10,00
Probability of Success of Previous Stage				60,0%	80,0%	90,0%	95,0%
Cumulative Probability of Survival			100,0%	60,0%	48,0%	43,2%	41,14%
Probability-adjusted CF Forecast			-7,00	-1,20	0,00	2,16	4,11
Adjusted Cash Flows							
Discount Factor	12,0%		1,00	0,89	0,80	0,71	Sum
Discounted Cash Flows			-7,00	-1,07	0,00	1,54	-6,53
Terminal Value							
Growth	2,0%	41,14					
Dicounted TV		29,28					
Enterprise Value		22,75					

Excursion – On Negotiation

The Fog of War

The Fog of War: Eleven Lessons from the Life of Robert S. McNamara

- Empathize with your enemy
- Rationality will not save us
- There's something beyond one's self
- Maximize efficiency
- Proportionality should be a guideline in war
- Get the data
- Belief and seeing are often both wrong
- Be prepared to re-examine your reasoning
- In order to do good, you may have to engage in evil
- Never say never
- You can't change human nature



The 14 Basic Child Negotiation Skills

- Throw a tantrum



- Ask the person who's most inclined to say "yes"

- Play one side against the other

- Get sympathy



- Take your time

- Change the rules

- Solicit a bribe

- Wear the other side down

- Turn the negotiations into a game

- Act irrationally

- Worry the other side that you might be sick


- Make weak promises

- Win through cuteness



- Take your toys and go home

Key Questions in Negotiations

- 
1. BATNAs “ What if no agreement?
 2. Parties “ Who are the real parties in the negotiation?
 3. Interests “ What are fundamental needs / priorities?
 4. Value “ How to create value / Who is likely to get it?
 5. Barriers “ What obstacles might prevent agreement?
 6. Power “ Parties’ influence on negotiation process
 7. Ethics “ What is the right thing to do?

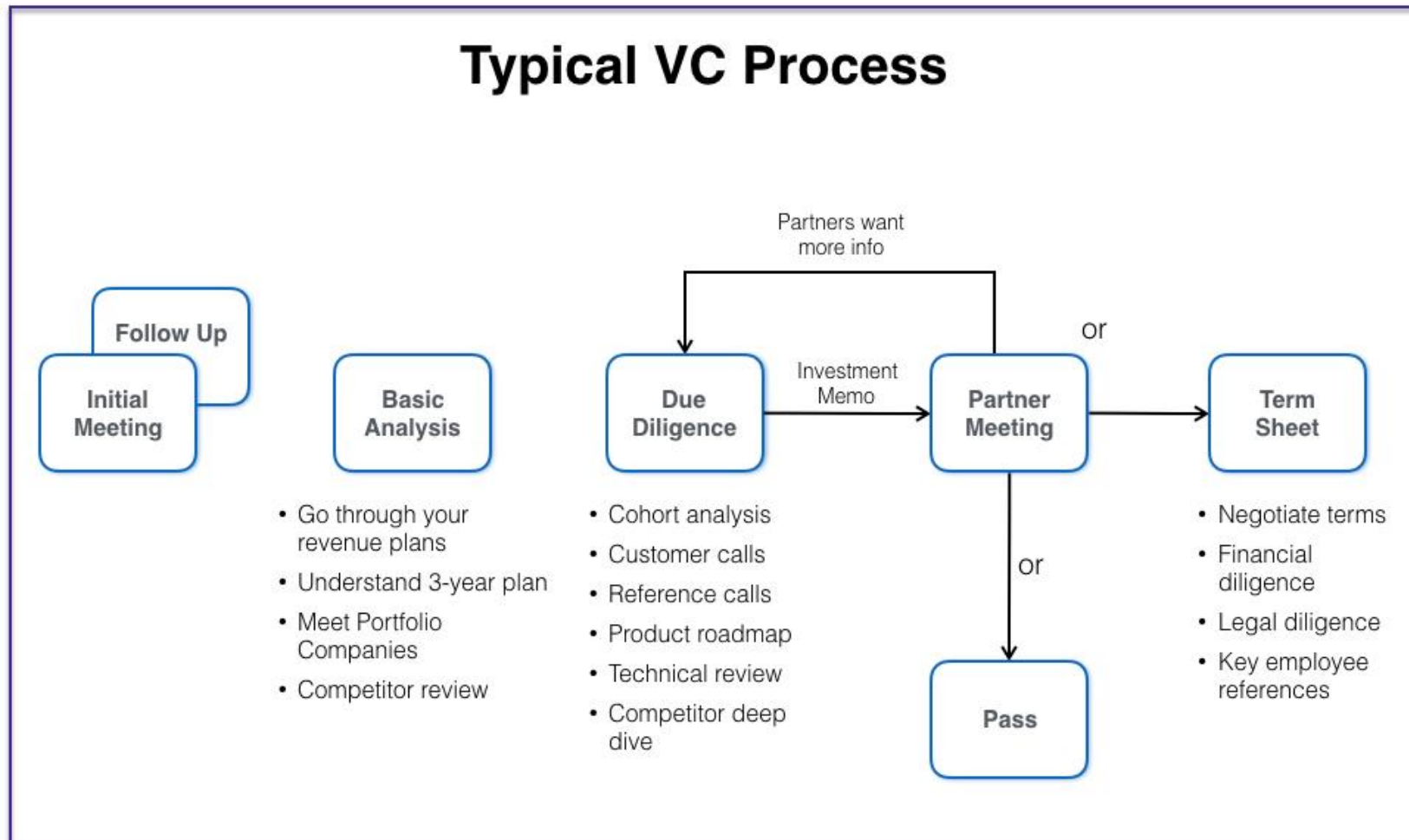
Appendix

Investment Process

Process: Source → Learn → Invest → Exit

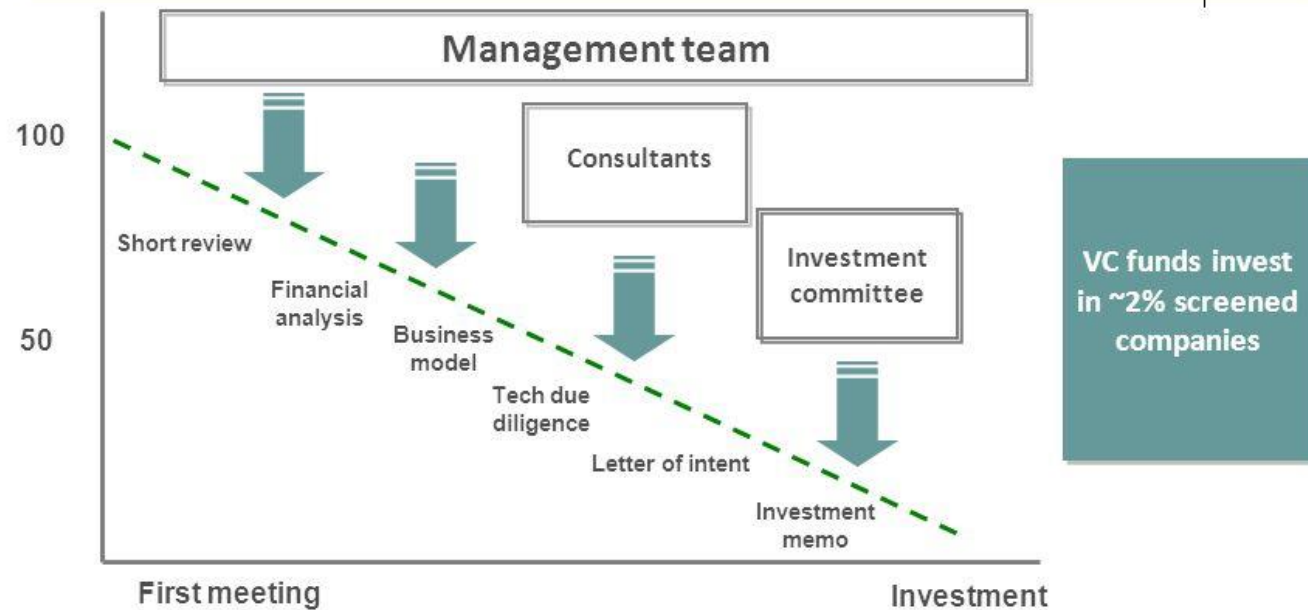


Investment Process



Investment Process

From presentation to investment



Investment process usually lasts from 4 to 9 months

LCM

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Contact

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